
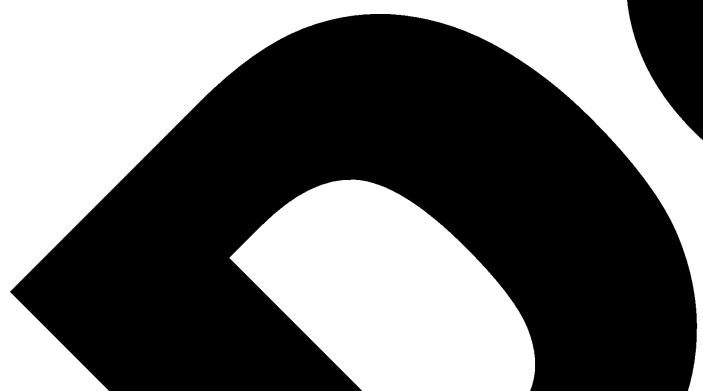


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DIRECTORATE OF  
INTELLIGENCE

# Intelligence Memorandum

*Peru's Short-Run Economic Prospects*

**Secret**

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May 1969

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CENTRAL INTELLIGENCE AGENCY  
Directorate of Intelligence  
May 1969

INTELLIGENCE MEMORANDUM

Peru's Short-Run Economic Prospects

Summary

The threat of impending economic sanctions under the Hickenlooper and Sugar Act Amendments and the continuing stabilization program resulted in a slowdown in economic growth in early 1969 from the 2 percent rate recorded in 1968. Despite the loss of large amounts of short-term credit, the existence of relative price stability and a growing level of foreign reserves has given the military regime a considerable degree of flexibility in determining its economic policies during the remainder of 1969, and economic growth may rise during this period. Imposition of formal economic sanctions probably would have only a marginal additional impact on the Peruvian economy during 1969, and it is unlikely that Peru will find it necessary for economic reasons to take steps which would make foreign private investment in Peru less attractive. The imposition of formal economic sanctions will, however, dim her long-term economic prospects.

The Peruvian economy grew at a comparatively rapid rate during the early 1960's, but growing budget deficits, rising prices, and worsening balance of payments problems caused a loss of business confidence and forced a devaluation in 1967. A stabilization program initiated in mid-1968 has been successful in cutting the budget deficit and slowing inflation. Import taxes and other prohibitions helped to curtail imports sharply while exports increased 14 percent, largely as a result of higher world prices for Peru's major export products.

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence.

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**SECRET**The Setting

1. Peru achieved one of the highest rates of economic growth in the hemisphere during the period 1962-67. Concurrently, the economy suffered from growing problems of inflation and balance-of-payments disequilibrium, largely as a result of increasingly large budget deficits which necessitated heavy domestic and foreign borrowing. Due to a continuing deterioration in the balance of trade -- as well as widespread capital flight resulting from a crisis in business confidence -- Peru was forced to devalue the sol by 31 percent in September of 1967. The devaluation resulted in an immediate improvement in the balance of trade. However, bitter factional opposition in the Peruvian Congress prevented the Belaunde administration from reforming the antiquated and inelastic tax structure which was the major cause of the growing budget deficit. As the economic crisis deepened, widespread capital flight continued.

2. In July 1968, the deteriorating economic situation finally impelled the Congress to grant special powers to the Belaunde administration, and a stabilization program was launched under the direction of Finance Minister Manuel Ulloa. The Ulloa program combined tax reforms to substantially increase revenue with moderate cuts in expenditures and strong curbs on credit. At the same time, the government moved to refinance its foreign debt, scheduled service payments on which had grown to \$133 million by 1968 -- or about 15 percent of export earnings and 21 percent of government revenues. Ulloa also attempted to attract new foreign investment, especially in mining. Future export earnings from the new productive capacity would facilitate rescheduled foreign debt payments falling due in the early 1970's. In addition, Ulloa arranged a \$75 million stand-by loan from the International Monetary Fund (IMF).

3. When the present military government led by General Juan Velasco assumed power on 3 October 1969, it adopted the Ulloa program almost in its entirety and implemented it even more energetically than had the Belaunde administration. The debt refinancing operation was successfully completed before the end of 1968. Additional cuts in domestic expenditures were made. In order to compensate for a fall in revenues from import taxes,

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the military government also made permanent a 10-percent surcharge on imports originally adopted as a balance-of-payments measure in May 1968.

4. A new dimension was added to the Peruvian economic scene by the seizure of the Talara refinery of the International Petroleum Company (IPC). While the move assured popular support for the regime, nullification of the Act of Talara\* by the Velasco government set Peru and the United States on a collision course. The Hickenlooper Amendment to the US Foreign Assistance Act and similar provisions in the Sugar Act require the President to cut off all economic and military assistance and to suspend the sugar quota of any nation which fails to take steps toward prompt, adequate, and effective compensation within six months of expropriating the property of an American citizen or company. Because the Peruvian government assumed an apparently intransigent position regarding compensation, most observers fully expected that the sanctions would be invoked in early April 1969. Four days before the sanctions were scheduled to be invoked, the US indefinitely suspended their application in the hope that the issue could be resolved by an IPC appeal through Peruvian administrative channels which is scheduled to be concluded no later than 6 August 1969.

Impact of the Stabilization Program

5. Fiscal austerity -- the keynote of the stabilization program particularly under the military government -- has brought a dramatic improvement in the government's budgetary performance. The original stabilization program included domestic expenditure cuts of about 1 billion soles and new tax measures to increase revenues by 2.5 billion soles during fiscal year 1968 (April 1968 to March 1969). The military government cut domestic expenditures by an additional 0.6 billion soles while further increasing revenues 0.4 billion soles by extending the 10-percent import surcharge. Total expenditures were also reduced by the successful completion of refinancing negotiations which

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postponed scheduled debt repayments. The net effect of these changes through the end of fiscal year 1968 is shown in the following tabulation:

<u>Calendar Year</u>	<u>Million Soles</u>			Deficit or Surplus as a Percent of GDP
	<u>Revenues</u>	<u>Expendi- tures</u>	<u>Deficit</u>	
1963	13,808	15,027	-1,219	1.5
1964	13,467	16,185	-2,718	2.9
1965	15,546	19,919	-4,373	3.8
1966	17,593	22,714	-5,121	3.9
1967	20,120	28,344	-8,224	5.5
1968	24,220	29,410	-5,190	2.7
Fiscal year 1968 (Apr 68 - Mar 69)	25,373	27,466	-2,093	1.1
First quarter 1968	6,420	8,693	-2,273	5.1 (annual rate)
First quarter 1969	7,573	6,749	+824	1.7 (annual rate)

6. The stabilization program has succeeded in virtually halting inflation. The consumer price index for Lima-Callao increased only 1.6 percent from July 1968 to February 1969. An additional rise by 3.0 percent in the index for March and April is not an indication of a resurgence in inflationary pressures. The price increase resulted from a temporary shortage of foodstuffs in Lima because landslides in central Peru blocked transportation routes. Monthly rates of inflation from 1966 through early 1969 are presented in the following tabulation:

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	Percent			
	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>
Annual rate of increase (December to December)	7.7	20.7	9.8	
January	0.7	1.7	1.5	0.4
February	0.8	0	0.6	0.4
March	0.7	0.9	1.1	1.4
April	0.1	0.5	0.7	1.6
May	0.1	1.6	0.8	
June	0.6	0.4	2.6	
July	1.1	0.5	1.3	
August	1.0	0.4	0.6	
September	-0.5	6.4	-0.4	
October	1.2	2.5	0.2	
November	-1.1	0.9	0	
December	0.3	3.3	0.4	

7. The devaluation and subsequent stabilization measures combined with rising world market prices for some key exports have been highly effective in changing a substantial trade deficit into a large trade surplus. The value of exports increased by 14 percent in 1968 with earnings from exports of copper, fishmeal, and silver showing the most rapid increases. At the same time, imports fell by 23 percent as import costs rose because of the devaluation and the imposition of an import surcharge and as demand for investment goods weakened. In addition, the heavy stockpiling of imports, which had taken place in anticipation of the devaluation, largely ceased after 1967. A ban on the import of luxury automobiles was the major cause of a 58 percent drop in imports of transportation equipment. Imports of other consumer goods declined by 8 percent, capital goods by 27 percent, and industrial raw materials by about 15 percent. The balance on trade account improved by almost \$300 million in 1968, and a strong export surplus continued into early 1969 as a result of a continued high level of exports and a further sharp decline in imports. The following tabulation of exports and imports based on customs data compares performance during this period with that of earlier years:

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	Million US \$		
	Exports (f.o.b.)	Imports (f.o.b.)	Balance
1964	667	580	+87
1965	667	729	-62
1966	764	817	-53
1967	757	819	-62
1968	866	630	+236
First quarter 1967	188	208	-20
First quarter 1968	229	167	+62
First quarter 1969	212	136	+76

8. In 1968, Peru's net foreign reserves increased by \$50 million, compared with a loss of \$120 million in 1967. Largely as a result of the sharp improvement in the balance of trade in 1968, the balance on current account showed a surplus after several years of large deficits. Moreover, despite a sharp drop in loan disbursements, the net inflow of official capital again totaled some \$105 million, thanks to a reduction in debt repayment. The net outflow of short-term capital, however, reached an estimated \$100 million. The shift to a negative balance on importers' credits -- estimated at some \$75 million in 1968 -- largely reflected the reduced need for short-term financing as imports fell by about \$190 million. Part of the contraction in short-term credit outstanding, however, probably stemmed from increasing reluctance on the part of lenders to extend credit while Peru was under the threat of sanctions by the United States.

9. Largely as a result of the stabilization program, economic growth slowed from 4.6 percent in 1967 to roughly 2 percent in 1968, compared with a rate of growth in population of about 3 percent. It is probable that the rate of economic growth slowed even further in early 1969. Most of this slowdown resulted from the stringent controls on fiscal and credit operations which were imposed under the austerity program and which have been

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progressively tightened through the first quarter of 1969. In addition, uncertainty over the new regime's economic policies probably reduced investment activity after October, thus further complicating existing recessionary conditions. The economic slowdown undoubtedly has contributed to a rise in unemployment as additions to the rapidly growing labor force have been increasingly difficult to absorb.

10. Per capita private consumption, however, probably has been maintained largely at the expense of investment in inventories and machinery. Despite the decline in per capita GDP and in imports, it is doubtful if there has been any appreciable shortage of consumer goods and raw materials. In anticipation of devaluation, inventories had been heavily built up in 1966 and 1967. During this period, inventory investment averaged 4.4 percent of GDP, well above the average rate of about 2.5 percent in the early 1960's. Moreover, pockets of prosperity continue to exist in important sectors of the economy. Output of export industries and import-competing industries in particular has grown during the period since devaluation.

#### Peruvian Options in the Face of US Economic Sanctions

11. The threat of sanctions had the effect of reinforcing the recessionary effects of the stabilization program. Business confidence dropped and economic activity slowed, as uncertainty over impending sanctions delayed management decisions. As the six-month deadline for the imposition of economic sanctions approached, this uncertainty had an increasing effect on the Peruvian economy. US and foreign bankers and businessmen began to curtail bank credits and supplier loans and to temporarily defer intended investments in Peru. This, in turn, imposed an added burden on domestic credit sources -- already strained by the credit restraints of the stabilization program -- as borrowers who had traditionally depended on foreign credit were forced to turn to domestic sources. The Peruvian authorities nevertheless opted to pursue very conservative fiscal and monetary policies during this period.

12. Because of the success of the administration's austerity program, the Peruvian economy

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should be able to absorb the additional short-run impact of actual sanctions. It should be able to do so, moreover, without finding it necessary for economic reasons to take retaliatory actions which would adversely affect much-needed foreign investment. The relative price stability and improvement in foreign reserves thus far achieved gives the Peruvian government considerable flexibility in its economic policy options during the remainder of 1969. The government could choose to adhere rigidly to the stabilization program in order to accumulate foreign reserves at a rapid rate. On the other hand, the government is in a position to adopt more expansionary programs, although at some cost in reserves and a resurgence of a degree of inflationary pressure. At this point, it should be possible for the Peruvian authorities to inject a degree of liquidity into the economy sufficient to maintain output and perhaps achieve some growth without driving the rate of inflation to a damaging level at least in the short run. The Peruvian government now appears to be moving toward the adoption of this alternative.

Short-Run Prospects

13. Peru's short-run economic prospects are for a slow expansion. Real economic growth during 1969 will probably be less than the 3 percent annual rate of growth in population. Although the rate of growth was very low in the first quarter, it will probably rise in the course of the year. However, continued improvement in the terms of trade may prevent a decline in the level of per capita income. It is probable that unemployment will grow gradually, particularly among new entries into the labor force. It is unlikely, however, that industrial unemployment will be sharply increased by large layoffs or that it will seriously threaten the stability of the government over the short run. Although the government recently dismissed several thousand public employees, its overall policy is likely to stimulate some increases in employment. The government has recently announced a 42-percent increase in public investment expenditures in 1969, and it is probable that much of this expenditure will be directed toward public works projects with a high labor and low import content. Moreover, the recent

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selective relaxation in credit restrictions is also likely to lead to some small increases in domestic investment and employment.

14. The budget expenditures for the remainder of 1969 are projected to increase by 8.3 percent in current soles over the revised 1968 budget. The rise in current expenditures is to be held to 2.3 percent in order to facilitate the large increase in capital expenditure. At the same time, the government has given high priority to further tax reform, and a tax commission was appointed in late April to recommend changes by 30 June. Although no detailed projections of revenue have been presented, the finance minister has indicated that financing would be required for a deficit of only about 1 billion soles. Although actual performance may fall short of the government's expectations, a further reduction in the budget deficit appears likely during calendar year 1969.

15. Inflation is unlikely to present a major problem for the regime during the remainder of 1969. Fiscal operations promise to continue to be much less inflationary than in past years, while restrictions on domestic credit will also continue to restrain demand. The slight relaxation in domestic credit restrictions in April was largely a response to the contraction in available foreign credit and is not an indication of an abandonment of credit restraint. Although further loosening of credit probably will occur, the Central Bank can be expected to keep overall credit expansion within manageable limits.

16. Peru's exports in 1969 should equal or exceed those of 1968. Copper output should increase by about 5 percent as a result of investments in small and medium-sized mines in 1968. Moreover, the average price received thus far in 1969 has exceeded the 1968 average by about 2 percent. Fishmeal shipments should continue at a high level, although they may decline by as much as 15 percent from the record levels of 1968. Although production of meal declined 46 percent during January and February because of a 30-day prohibition on anchovy fishing (a normal conservation measure), fishing began again in early March. The volume of exports during this period declined

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only 14 percent, however, as shipments were made from stocks. As of the end of February, Peru had fishmeal stocks equal to about 15 percent of last year's record exports and could continue to draw upon these to compensate for any shortfalls in the catch. Fishmeal prices are continuing their upward trend and during the first quarter of 1969 averaged almost 17 percent above the average for 1968. Cotton exports are moving especially well thus far in 1969. First quarter shipments exceeded those of the same period in 1968 by 83 percent. Production of sugar, however, has been adversely affected by continuing drought conditions, and exports have declined substantially. The outlook for Peru's other exports, mostly diversified mineral products, is for a slight increase in volume, while prices remain at about their 1968 levels. Table 1 presents exports for 1967 and 1968 as well as an estimate of their probable levels in 1969.

17. Imports are expected to remain at a low level in 1969 as a result of the slowdown in the rate of economic growth, the continuing effects of the devaluation, continuation of the import surcharge and the prohibition upon luxury imports, and some hesitancy on the part of investors. In addition, the shortage of import financing from traditional sources is a continuing check on imports. Limited relaxation of credit to the private sector probably will result in some increase in import demand. However, given the generally bearish economic outlook, the lack of devaluation jitters, and the stricter control now being exercised by the Central Bank, reversion to widespread stockpiling by importers is unlikely.

18. Private foreign investment appears to be on the increase. The inflow of long-term private capital had virtually ceased during the latter portion of 1968 and early 1969, but since February about \$64 million in new investment contracts have been finalized or are near finalization. In addition, many international oil companies rushed to obtain offshore concessions in late 1968. Moreover,

[redacted] the Minister of Development has announced an offer of credit from Japan of more

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than \$30 million to refurbish the Talara refinery. Peru also has obtained \$37 million in new official loans and grants since the beginning of the year (see Table 2). The outlook for further improvement in receipts of official loans is unpredictable, as it will be affected by future decisions regarding the invocation of sanctions.

19. The level of reserves is expected to continue to improve in 1969 -- perhaps at an annual rate of about \$80-\$90 million if sanctions are not imposed and if Peru continues to pursue conservative economic policies -- despite somewhat lower levels of net official lending and further contractions in foreign short-term and import credit (see Table 3). Net Central Bank reserves increased by \$28 million for the first quarter of 1969. The March figures may have been inflated by some window-dressing operations, however. In particular, profit remittances reportedly have been held up in processing by a special committee in the Central Bank. Such action, which is contrary to the IMF standby agreement, would artificially inflate the reserve figures. Most of the reserve increase has been real, however, and it is probable that Peru will be able to meet both the reserve and expenditure requirements under the IMF standby agreement. Thus, provided that the restrictive practices are halted, Peru may be eligible to draw the May tranche of \$17.5 million.

#### Effects of the Imposition of Sanctions

20. Invocation of the Hickenlooper and Sugar Act Amendments is unlikely to cause serious additional short-run economic problems for Peru. Further losses in economic assistance would be slight during 1969, as there have been few US assistance loans to Peru since 1967, and most disbursements on existing loans are presently being delayed indefinitely. Although no new loans would be forthcoming from the Export-Import Bank, the IBRD, or the special funds of the IDB, disbursements on existing loans from these agencies would continue. Total receipts of official capital in 1969 are expected to run at close to their 1968 level, regardless of whether or not sanctions are imposed.

21. Similarly, imposition of formal sanctions will not have a large impact on the sugar industry

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or on Peru's foreign exchange earnings in 1969. As a result of drought, Peru will have only about 300,000 tons of exportable sugar, in contrast to a normal exportable surplus of 450,000 tons or more. Of the amount available for export, it is likely that 200,000 tons or more will have been shipped by the time sanctions are imposed. The prospects for the sugar industry for 1970 would be dismal as a result of the sanctions, however, as domestic production costs are considerably above the current world market price. Given a normal level of exports, Peru stands to lose some \$25-\$35 million in foreign exchange earnings in 1970 if its quota is revoked.

22. Even if the sanctions are invoked in August 1969 or earlier, Peru's net foreign exchange reserves will probably continue to increase at least until the year's end. Peru probably will not find it economically necessary to interfere with profit remittances by US or other foreign companies, but could do so for political reasons. Imposition of the sanctions would have little impact on export receipts and long-term credit inflows during 1969. Sanctions probably would lead to further losses in short-term credit and import financing, and stronger exchange controls might be necessary to contain an increase in capital flight. These losses would be limited, however, by several factors: competitive pressures will induce many suppliers to continue financing imports; foreign banks are likely to continue to accommodate their old and trusted customers; foreign subsidiaries operating in Peru account for a sizable portion of Peru's imports of industrial raw materials and can be expected to continue to receive accommodation from their parent companies; and, of the estimated \$350-\$400 million in total short-term credit outstanding at the beginning of 1968, a large part of the credit subject to rapid recall probably already has been called back. Outstanding short-term credit declined by approximately \$75-\$100 million in 1968 and probably has declined by an additional \$30-\$40 million thus far in 1969.

23. The outlook for Peru's long-term economic development will be severely dimmed by the imposition of sanctions. The strength of US influence in many international lending agencies makes it

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very unlikely that Peru will be able to obtain sufficient new official loans to replace more than a portion of those presently being disbursed. It is likely, however, that there would be an increase in government-guaranteed supplier credit from Western European countries and Japan. The long-anticipated mining investments by US companies -- valued at some \$600-\$700 million -- will be further delayed by the sanctions, as many of them depend heavily upon financing from the Export-Import Bank. In addition, the sanctions could dissuade other US banks and companies from investing in or lending to Peru. However, if Peru takes no discriminatory action against private foreign investors in reaction to the imposition of formal sanctions, other foreign investments -- especially those by non-US companies -- may be expected to continue on a nearly normal basis. In addition, Japanese companies, which already import almost all of Peru's iron ore production and much of Peru's output of lead, silver, and zinc, are likely to take advantage of the situation to expand their interests in Peru -- even to the extent of being willing to take over existing mining concessions held by US companies. Moreover, the attractiveness of Peruvian concessions (which might be lost if they remain unexploited for much longer) may eventually induce the US mining companies to seek alternative sources of financing in order to develop them.

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Table 1

## Commodity Composition of Exports

				Million US \$
	1967	1968	1969 a/	Assumptions
Fish and derivatives	204.0	234.3	245	Volume decrease from 2.074 million tons to 1.9 million tons, price increase of 17 percent.
Copper	198.3	234.0	245	Volume increase from 206,800 tons to 215,000 tons as a result of new Chapi mine.
Silver	42.3	67.9	70	
Iron ore	62.1	63.3	65	
Sugar	53.1	62.7	34 to 41	200,000 tons to the United States under quota equals \$27.4 million; 100,000 tons on the world market at \$0.035 per pound equals \$7.0 million. If sanctions are not invoked, all sugar would be sold to the United States under quota for about \$41 million.
Cotton	54.8	55.8	70	Recovery to more normal levels.
Coffee	29.1	35.7	38	
Zinc	35.7	33.2	33	
Lead	30.2	29.4	30	
Petroleum	8.5	11.3	10	
Wool	8.2	9.4	10	
Other	30.7	29.1	30	
<i>Total</i>	<i>757.0</i>	<i>866.1</i>	<i>880 to 887</i>	

Table 2

Known Contracted Private Investment and Authorization of Official Capital  
During Early 1969

Foreign Private Investment Projects				
Activity	Company	Timespan	Date Finalized	Foreign Capital Content (Million US \$)
Iron mining	Marcona Mining (US)	1969-70	March	3
Iron mining	Marcona Mining (US)	1969-70	Pending	25
Electricity	Lima Light - Power Company (Swiss)	1969-73	March	24 <sup>a/</sup>
Chemicals	Bayer (West Germany)	1969-70	April	12
Official Grants and Loans				
Lender	Purpose	Disbursement Period	Date Authorized	Amount (Million US \$)
Netherlands	Varied	1969-71	February	10.5
Union of South Africa	Irrigation	1969-74	April	14.0
Interamerican Development Bank	Housing	1969-74	April	12.5

a. \$17.5 million of this sum is to be financed by a loan authorized by the IBRD in 1967. Swiss financing for the remainder was arranged in March 1969.

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Table 3

Estimated Balance of Payments a/

	Million US \$		
	<u>1967</u>	<u>1968</u>	<u>1969</u>
Current account balance	<u>-248.3</u>	<u>44.6</u>	<u>57</u>
Exports (f.o.b.)	755.1	866.1 <u>b/</u>	890 <u>b/</u>
Imports (f.o.b.)	797.7	630.0 <u>b/</u>	630 <u>b/</u>
Trade balance	-42.6	+236.1	+260
Freight and insurance	-82.1	-65.0 <u>c/</u>	-65 <u>c/</u>
Interest payments	-46.6	-60.5	-68
Other investment income	-93.3	-90.0	-90
Transfers and other services	16.6	24.0	20
Official capital	<u>106.4</u>	<u>105.4</u>	<u>88</u>
Disbursements	169.5	126.8	123
Amortizations	-63.1	-59.4	-113
Refinancing proceeds		38.0	78
Long-term private capital	<u>26.6</u>	<u>10.0</u> <u>d/</u>	<u>20</u> <u>d/</u>
Short-term capital	<u>23.9</u>	<u>-100.0</u>	<u>-80</u>
Credit to importers	28.1	-75.0 <u>e/</u>	-50 <u>e/</u>
Peruvian commercial banks	29.5	-5.0	-5
Other	-33.7	-20.0 <u>f/</u>	-25.0 <u>f/</u>
Errors and omissions	<u>-29.2</u>	<u>-9.5</u>	
Surplus (+) or deficit (-)	-120.6	50.5	85

a. Except as noted, estimates are derived from material provided by the Embassy. Estimate for 1969 is based on the assumption that applications of sanctions will remain in suspension and that Peru will continue to pursue conservative economic policies. Imports would rise somewhat in response to an adoption of more expansionary policies.

b. From customs data. This data is normally revised for balance of payments purposes. Since 1963 these revisions have reduced imports by an average of \$40 million while increasing exports by an average of \$15 million.

c. Based on the ratio of freight and insurance payments to imports in 1967.

d. Based on probable inflow on committed investment.

e. Based on estimated reduction in import financing due to decline in imports and lower credit availability as a result of threat of sanctions.

f. Estimated capital flight.

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